DEPARTMENT OF STATE REVENUE
SUPPLEMENTAL LETTER OF FINDINGS: 01-0041
Indiana Corporate Income Tax
For the Tax Years 1993 through 1996

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ISSUES

I. Calculation and Reporting Errors.

Authority: IC 6-8.1-5-1(b); 45 IAC 3.1-1-45.

Taxpayer argues that the original audit report contained certain computational and reporting errors which were not resolved within the original Letter of Findings.

II. Gross Income Tax Calculation.

Authority: IC 6-2.1-2-2(a)(1); IC 6-2.1-2-2(a)(2); IC 6-2.1-2-2(b); IC 6-2.1-2-3; IC 6-2.1-2-4; IC 6-2.1-2-5; IC 6-2.1-2-5(9); IC 6-8.1-5-1(b).

Taxpayer takes exception to the audit's determination as to the amount of its gross income subject to the high rate.

III. Apportionment Sales Factor – Adjusted Gross Income Tax.

Authority: 45 IAC 3.1-1-50(5); 45 IAC 3.1-1-55(e); Sherwin-Williams Co. v. Indiana Dept. of State Revenue, 673 N.E.2d 849 (Ind. Tax Ct. 1996); AT&T v Director, Division of Taxation, 476 A.2d 800 (N.J. Super. A.D. 1984).

Taxpayer restates that – for purposes of calculating the sales denominator – the audit erred in excluding income received from the sale of short term securities.

IV. Ten-Percent Negligence Penalty.

Authority: IC 6-8.1-10-2.1; IC 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer maintains that it is entitled to an abatement of the ten-percent negligence penalty assessed at the time of the original audit review.

STATEMENT OF FACTS

Taxpayer is in the business of manufacturing, distributing, and selling various paints and paint coatings. Taxpayer sells these products to professional, industrial, commercial, and retail customers. During the relevant period, taxpayer operated a manufacturing plant within the state. In 2001, the Department of Revenue (Department) completed an audit review of taxpayer's business records and tax returns. This audit review concluded that taxpayer owed additional Indiana corporate income taxes. Taxpayer disagreed with the audit's methodology, conclusions, and consequent assessments and submitted a protest to that effect. In 2003, an administrative hearing was conducted during which taxpayer explained the basis for its protest. As a result, the Department issued a Letter of Findings denying in part and sustaining in part the taxpayer's protest. Nonetheless, taxpayer disagreed with those portions of the Letter of Findings denying taxpayer's initial protest. Therefore, taxpayer requested the opportunity to provide additional information at an administrative rehearing. That request was granted; an additional hearing was conducted, and this Supplemental Letter of Findings results.

DISCUSSION

I. Calculation and Reporting Errors.

Taxpayer reasserts three arguments pertaining to factual and reporting "errors" purportedly contained within the original audit report and which remained unresolved following publication of the original Letter of Findings. Specifically, taxpayer maintains that the audit report erred in the following manner:

A. **Real Property Rent Expense**. Taxpayer believes that – for purposes of determining the numerator of the property factor pursuant to 45 IAC 3.1-1-43 – the audit report overstated the amount of rent it paid for its Indiana paint manufacturing facility. The Letter of Findings found that taxpayer did not refute the audit report's conclusion as to the amount of rent. Taxpayer has now provided a copy of the lease agreement along with an amendment to that agreement representing the amount of monthly rent paid.

B. **Personal Property Rent Expense**. Taxpayer states that the audit erroneously listed the amount of personal property rent expense for 1993 by erroneously duplicating the amount listed for 1994. According to taxpayer, the audit overstated the amount of 1993 personal property rent expense by approximately $1,000.

C. **Average Inventory and Personal Property**. The audit calculated the average amount of inventory and personal property located at taxpayer's Indiana manufacturing facility. Taxpayer states that audit's arithmetic was flawed; in effect, taxpayer states that the audit made a computational mistake because the audit "forgot to divide by two."

In regards to the "Real property rent expense," taxpayer has provided a complete copy of the lease agreement for the Indiana paint manufacturing facility. The document indicates that taxpayer is required to make $5,600 in monthly rent payments. As taxpayer asserts, this amount alone is substantially less than the monthly rent expense reported in the original audit report.

However, taxpayer is incorrect in suggesting that the $5,600 monthly rental amount is the beginning and end of the calculation. 45 IAC 3.1-1-45 states in relevant part as follows:

> "Annual rent" is the actual consideration for use of the property and includes payment of a fixed sum of money or percentage of sales profits or receipts, as well as interest, taxes, insurance, repairs and any other items required as payment under the lease which are meant as additional rent or in lieu of rent.

The parties' lease agreement includes the requirement that taxpayer reimburse to the property owner, "[A]ll general real estate taxes and assessments for betterments or improvements which may be levied by any lawful authority against the premises." In addition, the agreement stipulates that taxpayer is to maintain liability and property insurance for the leased facility.

For purposes of computing the property factor, the rented property "is valued at eight times its annual net rental rate." 45 IAC 3.1-1-45. However, the $5,600 rate cited by taxpayer is only one portion of the formula. The value of rented property includes not only the base rate, but it includes the amount of taxes and any repairs or improvements made to the rented property. Id. To determine the value of the manufacturing facility, 45 IAC 3.1-1-45 requires that the base rent be multiplied by eight ($44,800). To that amount is added the costs of insurance, improvements, repairs, and any other expenses which taxpayer incurs under the terms of the agreement; all of these individual items are multiplied by eight.

Taxpayer's original protest as to the amount of "Real Property Rent Expense" was denied because taxpayer failed to provide a complete copy of the lease agreement between itself and the manufacturing facility's lessor. Taxpayer has corrected that oversight and supplied the agreement which clearly states that the monthly rate for the property is $5,600 per month. However, the Department is unable to conclude that that audit incorrectly calculated the amount of rent for the Indiana manufacturing facility. The amount stated in the original audit report is not unreasonable, and taxpayer has not provided sufficient evidence, as to the additional associated costs of the property, to specifically refute that amount. The factual and legal conclusions contained within the original audit report are presumed correct. IC 6-8.1-5-1(b). "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." Id. As to the property value of the rented Indiana manufacturing facility, taxpayer has failed to meet its burden of demonstrating that the original assessment was incorrect.

The audit division has reviewed taxpayer's remaining points of contention – the "Personal Property Rent Expense" and the "Average Inventory and Personal Property" – and has concluded that taxpayer's alternative computations are correct.

FINDING

Taxpayer's protest as to the "Real Property Rent Expense" is respectfully denied. Taxpayer's protest as to the "Personal Property Rent Expense" and the "Average Inventory and Personal Property" is sustained.

II. Gross Income Tax Calculation.

According to taxpayer, it "takes exception with the inclusion of certain receipts in the determination of the gross income tax based on high and low rate receipts." Taxpayer maintains that apportionment of its gross income as to high and low rate receipts was made "arbitrarily" and that taxpayer now "requests support for the numbers included in the high rate calculation."

Taxpayer has reframed the gross income tax issue from that posed in the initial protest and addressed within the original Letter of Findings. Originally, taxpayer maintained that the money received by its retail distributors for the delivery and installation of floor coverings was not subject to gross income tax at the high rate because taxpayer was acting in an agency capacity when it accepted this money. Taxpayer's original argument was that it was acting as an agent for the independent service providers who actually delivered and installed the floor coverings. The Department found no evidence of an agency relationship between taxpayer and the independent service providers. As stated in the original Letter of Findings, "The audit correctly determined that income obtained from the provision of [installation and delivery] services was subject to the gross income tax at the high rate pursuant to IC 6-2.1-2-3 and IC 6-2.1-2-5(9)." Taxpayer does not now challenge and the Department finds no reason to retreat from that original conclusion. However, taxpayer now maintains that the apportionment of its gross income between the "high" and the "low" rate was arbitrary and unsubstantiated.

IC 6-2.1-2-2(a)(1) imposes a gross income tax on "the entire taxable gross income of a taxpayer who is a resident or a domiciliary of Indiana . . . ." For a non-resident, the tax is imposed on, "the taxable gross income derived from activities or businesses or any other sources within Indiana by a taxpayer who is not a resident or domiciliary of Indiana." IC 6-2.1-2-2(a)(2) "The gross income tax is imposed at two rates, a "high rate" of 1.2 percent and a "low rate" of .3 percent. IC 6-2.1-2-3 "The rate of tax is determined by the type of transaction from which the taxable gross income is received." IC 6-2.1-2-2(b). The receipts from wholesale sales and from selling at retail are taxed at the low rate. IC 6-2.1-2-4. Receipts from service activities and other business activities are taxed at the high rate. IC 6-2.1-2-5.

According to the audit report, "This audit identified receipts for labor, services, and rent income from sample invoices and requested detail for each year by account." From this description, it appears that the audit calculated the apportionment of "high" and "low" rate income based on the sample invoices available at the time of the audit review. Taxpayer finds that this sampling method was deficient and that "no information was given to support the numbers."

The Department finds itself at something of a loss as to how address taxpayer's most recent protest concerning this gross income tax issue. If the audit had determined that taxpayer received $500 in service income – taxable at the high rate – but taxpayer provided information purporting to establish that it had actually received only $300 in service income, the issue would be amenable to either a legal or factual resolution. Taxpayer offers no such argument; it simply expresses a global dissatisfaction with the high/low rate apportionment. As stated in Part I of this Supplemental Letter of Findings, "The factual and legal conclusions contained within the audit report are presumed correct." *See* IC 6-8.1-5-1(b). From the narrative included within the audit report, it would seem clear that the audit did not review and tabulate each and every one of

taxpayer's invoices. Instead, it appears that the high/low rate apportionment was based upon a review and extrapolation of a set of "sample invoices." The Department is unable to agree with taxpayer that this particular accounting methodology was "arbitrary." Given the substantial size of taxpayer's business, it finds that the methodology was entirely reasonable. While taxpayer may be disaffected by the results, there is nothing upon which to base a conclusion that the audit based its conclusion as to high/low rate apportionment upon a whimsical or capricious methodology.

FINDING

Taxpayer's protest is respectfully denied.

III. Apportionment Sales Factor – Adjusted Gross Income Tax.

In reviewing the taxpayer's adjusted gross income tax returns, the audit excluded from the sales denominator "the principal returned in short term securities." In other words, the audit determined that "sales" income did not include the amount of principal realized when the taxpayer sold a short term security. Taxpayer continues to disagree and restates its original argument addressed within the original Letter of Findings. According to taxpayer, the audit erred when it excluded the "principal" income from the sales factor. As originally stated by taxpayer, receipts "generated by intangible personal property that produced business income should have been included in the numerator and the denominator of sales factor." The essence of taxpayer's argument is that gross receipts equals the amount received on the sale of investment securities including the interest earned and the principal.

In support of its premise, taxpayer points to 45 IAC 3.1-1-55(e) which states that "Gross receipts from intangible personal property shall, if classified as business income, be attributed to this state based upon the ratio which the total property and payroll factors in this state bears to the total of the property and payroll factors everywhere . . . ."

The Indiana Tax Court has addressed the specific issue raised by taxpayer and held, "'Gross Receipts' for the purpose of the sales factor includes *only* the interest income and not the rolled over capital or return of principal realized from the sale of investment securities." Sherwin-Williams Co. v. Indiana Dept. of State Revenue, 673 N.E.2d 849, 853 (Ind. Tax Ct. 1996) (*Emphasis added*). The Court found that "[P]rincipal included in the proceeds of sale or redemption of short term-investments is not includible in the receipts factor." Id. at 852. In arriving at that conclusion, the Tax Court cited to AT&T v Director, Division of Taxation, 476 A.2d 800, 802 (N.J. Super. A.D. 1984) which – in addressing the same issued raised by taxpayer – stated that "To include such receipts in the factor would be comparable to measuring business activity by the amount of money that a taxpayer repeatedly deposited and withdrew from its own bank account" and that to hold "otherwise produces an absurd interpretation of [the relevant statute]." Id. Taxpayer cannot logically contend that if it invested $100 in a security, sold the security, bought a second security with the same $100 and then repeated that process that six times during the same tax year, that it realized $600 in sales. Similarly, taxpayer cannot maintain that the $600 "sales" amount can be used as a means by which fairly and accurately determine

the taxpayer's Indiana income. The $600 figure is a bookkeeping fiction and represents neither real-world income nor sales.

The audit was correct when it excluded from both the sales numerator and the sales denominator "principal returned in short term securities transaction" because to do otherwise would not lead to an equitable apportionment of taxpayer's income. Taxpayer may not include the return of principal realized each time it sells investment securities because including both the principal and interest in each rollover amount would distort the sales factor by giving extra weight to its out-of-state sales. As stated in 45 IAC 3.1-1-50(5), "In some cases, certain gross receipts should be disregarded in determining the sales factor to effectuate an equitable apportionment."

Taxpayer's reliance on the general language contained in 45 IAC 3.1-1-55(e) notwithstanding, both the Indiana Tax Court and the Department have addressed this specific issue previously and – in each case – has rejected taxpayer's argument.

FINDING

Taxpayer's protest is respectfully denied.

IV. Ten-Percent Negligence Penalty.

Taxpayer argues that it is entitled to an abatement of the ten-percent negligence penalty because it "acted with reasonable cause and without the willful intent to underpay Indiana taxes."

IC 6-8.1-10-2.1 requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ."

The Department is unable to agree with taxpayer's contention that its preparation of the original tax returns represented a reasonable interpretation of the tax law and that in preparing those returns it "exercised ordinary business care." The taxpayer's erroneous decision to include principal from the sale of short term investment resulted in more than 60 percent of its additional tax liability. Taxpayer and the Department may continue to disagree on the question of whether gross proceeds generated by these investments should be included in the sales factor, but this *identical* issue has been twice protested, twice denied, and unsuccessfully litigated in the Tax Court. The Department does not doubt taxpayer's good faith interpretation of the tax law, but it is unable to agree that taxpayer's decision to include gross investment receipts in yet a audit third

cycle is indicative of the "reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." 45 IAC 15-22-2-(b).

FINDING

Taxpayer's protest is denied.

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